

Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the regulations, Michael P. Brewer, (202) 622-3980; concerning submissions of comments, the hearing, and requests to be placed on the building access list to attend the meeting, Treena V. Garrett, (202) 622-3401 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

Section 103(a) of the Internal Revenue Code of 1986 (Code) provides that, generally, interest on any State or local bond is not included in gross income. However, this exclusion does not apply to any private activity bond that is not a qualified bond.

*A. Mortgage Revenue Bonds*

Section 141(e)(1) provides that a qualified mortgage bond or a qualified veterans' mortgage bond (together, mortgage revenue bonds) issued under section 143 may be a qualified bond.

Sections 143(a)(2)(A)(ii) and 143(b) provide, in part, that for an issue to be an issue of qualified mortgage bonds or qualified veterans' mortgage bonds, respectively, the issue must satisfy the requirements of section 143(g). Section 143(g)(1) provides that an issue will meet the requirements of section 143(g) if the issue satisfies the requirements of section 143(g)(2) and, in the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, if the issue satisfies the requirements of section 143(g)(3).

Section 143(g)(2)(A) provides that an issue will meet the requirements of section 143(g)(2) only if the excess of (1) the effective interest rate on the mortgages provided under the issue, over (2) the yield on the issue, is not greater than 1.125 percentage points.

Section 143(g)(2)(B)(i) provides that in determining the effective rate of interest on any mortgage for purposes of section 143(g)(2), all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or the bond issue are taken into account.

Section 143(g)(2)(B)(ii) provides that, for purposes of determining the effective rate of mortgage interest, the following items (among others) shall be treated as borne by the mortgagor: (1) All points or similar charges paid by the seller of the property; and (2) the excess of the amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over

the usual and reasonable acquisition costs of a person acquiring like property when owner-financing is not provided through the use of mortgage revenue bonds.

Section 143(g)(2)(B)(iii) provides that, for purposes of determining the effective rate of mortgage interest, the following items shall not be taken into account: (1) Any expected rebate of arbitrage profits; and (2) any application fee, survey fee, credit report fee, insurance charge, or similar amount to the extent such amount does not exceed amounts charged in such area in cases when owner-financing is not provided through the use of mortgage revenue bonds. The exclusion for application fees, survey fees, credit report fees, insurance charges, or similar amounts does not apply to origination fees, points, or similar amounts.

In the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, section 143(g)(3) provides that certain earnings on nonpurpose investments must either be paid or credited to mortgagors, or paid to the United States, in certain circumstances.

In the Tax Reform Act of 1986, Pub. L. No. 99-514 (the 1986 Act), Congress reorganized sections 103 and 103A of the Internal Revenue Code of 1954 (1954 Code) regarding tax-exempt bonds into sections 103 and 141 through 150 of the Code. Congress intended that to the extent not amended by the 1986 Act, all principles of pre-1986 Act law would continue to apply to the reorganized provisions. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686.

Interpreting section 103A(i)(2)(B)(iii) of the 1954 Code, which is substantially identical to section 143(g)(2)(B)(iii) of the Code, § 6a.103A-2(i)(2)(ii)(C) of the Temporary Income Tax Regulations provides the following: "For example, amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not financed with qualified mortgage bonds. Premiums charged for pool mortgage insurance will be considered amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds." Pool mortgage insurance is not defined in the regulations.

*B. Qualified Guarantees*

Under § 1.148-4(f), for purposes of computing yield on an issue, fees paid

for a qualified guarantee for the issue are treated as additional interest on the issue. In general, a guarantee is a qualified guarantee if: (1) As of the date the guarantee is obtained, the issuer reasonably expects that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee; (2) the arrangement creates a guarantee in substance; and (3) the fees for the guarantee do not exceed a reasonable, arm's-length charge for the transfer of credit risk. The regulations provide that the guarantee of a loan of proceeds of an issue, as opposed to a guarantee of the issue, may constitute a qualified guarantee, but this rule does not apply to guarantees of mortgages financed with mortgage revenue bonds.

**Explanation of Provisions**

*A. Pool Mortgage Insurance*

Recently, questions have arisen regarding whether an issuer should be required to treat the portion of the interest payments on a pool of mortgages used to pay fees for a guarantee of a pass-through security backed by the pool of mortgages as an amount borne by the mortgagors that must be taken into account in determining the effective rate of interest on the mortgages for purposes of section 143(g). Taking the guarantee fees into account results in a higher effective rate of interest on the mortgages than if the fees were not taken into account.

The IRS and Treasury Department have determined that the guarantee fees should not be treated as amounts borne by the mortgagors that must be taken into account in determining the effective rate of interest on the mortgages for purposes of section 143(g). An issuer may achieve substantially the same result as not taking the guarantee fees into account in computing the effective rate of interest on the mortgages by substituting a qualified guarantee on the bonds for the guarantee of the pool of mortgages. If an issuer does not take the mortgage guarantee fees into account in computing the effective rate of interest on the mortgages, the difference between the bond yield and the effective rate on the mortgages is reduced because the effective rate on the mortgages is reduced. A qualified guarantee of the bonds accomplishes the same result by increasing bond yield, rather than reducing the effective rate of interest on the mortgages. Issuers should not be required to change the form of their transactions in these circumstances.